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RUEHLO/AMEMBASSY LONDON 0182
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C O N F I D E N T I A L SECTION 01 OF 02 LILONGWE 000037

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E.O. 12958: DECL: 01/13/2016
TAGS: EFIN EINV ETRD ECON MI
SUBJECT: MALAWI CABINET'S INTERNAL ECONOMIC DEBATE

REF: A. LILONGWE 0019
¶B. LILONGWE 0020

Classified By: Econoff W. Taliaferro,for reasons 1.4 b/d

¶1. (C) In a round of New Year courtesy calls on the finance minister and the governor of the central bank, Embassy has gained some new insights on cabinet-level thinking on economic issues. Among these are:

-- Recognition that subsidizing low maize prices has been a mistake
-- An upcoming devaluation of the kwacha in the very near future
-- Disagreement within the cabinet about controlling the exchange rate
-- Expectations that GOM will exceed the IMF targets for last quarter

While there are no major revelations here, we have learned that the GOM is dancing to the finance minister's tune on economic policy, but there is a lively debate behind the scenes. The IMF mission in February is an opportunity for some outside encouragement for greater independence of the central bank. End summary.

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GONDWE: HIGHER GRAIN PRICES, LOWER INTEREST RATES
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¶2. (C) In a courtesy call on 11 January, the Ambassdor was prepared to debate Finance Minister Goodall Gondwe on the GOM's continuing price subsidies on maize (ref A). Instead, he opened the topic with an admission that the government had made a "fatal mistake" in maintaining a price that is roughly half the market rate. He said the government had "tried to compete with the previous government for popularity" by keeping food prices low, and that it was costing them dearly. The GOM had budgeted to supply the parastatal ADMARC with 10,000 metric tons of grain per month, but "infinite demand" (caused by the Malawi government's continuing half-price sale on maize through ADMARC) had forced them to up the allocation to 20,000, with almost no effect on stocks. One of the ramifications of supplying the infinite demand for cheap food has been that the GOM has diverted some grain from its commitments to the humanitarian flow, which could result in a

humanitarian shortfall by March. Gondwe owned up to this as the GOM's problem, and said it has a "moral commitment" to make good on its obligation.

¶3. (C) Despite the budget hit from buying more maize than anticipated, Gondwe expects fiscal performance for the quarter just completed to be good, beating IMF targets. The main impact of higher food expenditures will be smaller principal payments on domestic debt, but that would still leave him ahead of the IMF domestic debt target. He anticipates a clean bill of fiscal health from the IMF's February mission and HIPC completion by June. (The February mission will provide a strong indication of Malawi's prospects for a June completion point.) Gondwe went on to say he expects to devalue the kwacha within the next month, without commenting on the current controversy over the Reserve Bank of Malawi's tactics for limiting forex remittances (ref B and below). He also said he will likely argue for lowering interest rates early in 2006, once HIPC completion becomes certain and the rainy season has run its course. (This is probably based on an internal GOM discussion about the inflation rate, in which some argue that monetary policy should look more to non-food inflation rather than the food-heavy top-line inflation figures, particularly in this drought year.)

A RUEFUL CENTRAL BANKER

¶4. (C) A conversation the next day with Reserve Bank Governor Victor Mbewe confirmed the existence of fault lines between

the government and the RBM. In a classic exercise of careful phrasing, Mbewe tacitly acknowledged that his bank has been slow-balling applications for foreign currency and thus effectively discouraging imports. He is clearly uncomfortable with this policy and attributed it to "an unfortunate tradition regarding the relationship between various institutions." Read: the finance ministry, and possibly the President, is forcing the RBM to break the rules of its IMF agreement. (As Trade Minister Martin Kansichi pointed out to us recently, the practice breaks not only the IMF's rules, but the WTO's as well.) As Mbewe ruefully put it, "This bank has become essentially the government's bank." Mbewe went on to say that the RBM is actively discussing the exchange rate issue with the government, and that it is near resolution--but that depends on some fairly challengin "issue management," namely, how to reconcile a devalued kwacha with the President's inaugural statement that he would "never" allow the kwacha to slip.

¶5. (SBU) Mbewe appeared to be less confident about interest rates than Gondwe. Whereas Gondwe had indicated clearly that rates could come down early in 2006, Mbewe could not identify a time frame for this to happen, saying that it would be difficult to do with the amount of liquidity left in the system. (One of the decisive factors in this debate may be the government's official measure of GDP. Gondwe told us his ministry is considering a revision to take into account the huge informal sector. He believes the current GDP figures are understated by about 60 percent--a conservative figure by most estimates. The informal sector, operating exclusively with currency, is largely unaffected by demand deposit parameters, and would account for the strangely inert "excess liquidity" in Malawi's monetary system.) Mbewe did, however, tell us that he is considering how to jump-start private lending. RBM and the finance ministry are pondering a move based on the relatively low non-food inflation rate; Mbewe indicated he would try to move rates before lowering the liquidity reserve requirement for banks.

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COMMENT: NOT QUITE BROKEN, BUT IT NEEDS FIXING
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¶6. (C) While these conversations hardly constitute an epiphany on Malawi's economic policies, they do bring out some nuances. Most importantly, it is clear that Gondwe is manipulating monetary policy to hit IMF fiscal targets; specifically, he is keeping the kwacha high as long as the GOM is importing food and fertilizer for this hunger season. With the import season winding down, he will soon be ready to let the kwacha drift. We also find it interesting that the Cabinet has not given Gondwe unquestioning support. Private sector interests are being represented by the trade minister and the central banker, although they have not prevailed up to now, and we got the impression that the key economic actors have been shouting at one another and intensely jostling to achieve the President's ear.

¶7. (C) Finally, it appears that the prospect of an IMF mission in February is heating up an internal debate over foreign exchange policy. It should also start a debate about the RBM's institutional independence and the necessity of its playing by the rules. As things stand now, the bank serves only government's interests, possibly to the detriment of a private sector that is starved for affordable capital. While Gondwe surely has the nation's broadest interests at heart (the game really is about fiscal discipline at this point), an independent central bank would be a valuable--and in the final analysis, necessary--counterbalance to the government's unilateral power in setting monetary policy.
EASTHAM